ECON 421 – INTERNATIONAL FINANCE
FALL 2012

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I. Overview

International Finance is a field alternately known as Open Economy Macro or International Monetary Macro, and its counterpart is the micro field of International Trade. The course builds on intermediate macroeconomics to understand how international financial flows and exchange rates impact economies and the policy responses available. The specific topics covered include exchange rate determination, monetary and fiscal policy in an open economy (that is, an economy that trades goods and assets with the rest of the world), balance of payments, the choice of exchange rate systems, and international debt. The course will then apply the tools developed to explore current issues such as the Eurozone crisis, the US current account deficit and global financial imbalances, the Chinese exchange rate, and balance of payments/currency crises in emerging and developing economies. This course takes a public policy approach to the material, while MGMT 657 takes a more operational approach to the same topics. Accordingly, this course will not focus on trading strategies or firm-level risk management.

The course will initially hammer the core theoretical tools in international macro, which require practice to master. Hence the intensity of problem sets will be front-loaded. We will have a mid-term exam after that segment has been finished (roughly late Sept/early Oct). From there we have fun applying these tools to interesting real-world issues. We will have a second mid-term exam Nov 20. The final week of classes will focus on developing research papers, but may include some lecture time if needed.

II. Course materials

Paul R. Krugman, Maurice Obstfeld and Marc Melitz, "International Economics: Theory and Policy" (9th edition, Prentice Hall, 2012), ISBN: 0138018987.

Further readings from the financial press (such as The Economist) economics journals, and other sources will be assigned and discussed during the course.

I will post lecture notes after each lecture, typically in a timely fashion. However, there is no guarantee that the notes are complete – more often than not they will be abbreviated – and hence they are no substitute for taking good notes in class.

All assigned reading is mandatory and should be done prior to the class in which we will discuss it. You will get more out of lectures this way, and you can participate more meaningfully in class. Some readings may be posted for supplementary purposes only, but this will be clearly indicated.

III. Evaluation

Problems sets, exams and the research paper form the core of grades, but class participation (quality, not quantity) counts. The matrix below adds up to 105% out of 100% to provide a little slack.

Mid-term (each)	30%
Research paper	30%
Problem sets	10%
Class participation	5%

Research papers require you to ask a interesting question, relevant to the course material, whose answer is not obvious (i.e. interesting) and answer it with fewer than 2500 words.

- Topics can be about current policy debates (e.g. exchange rate regime choice, use of capital controls, effectiveness of central bank intervention, impact of the US dollar on commodities, etc…), debates about issues in historical periods (e.g. Gold Standard, Latin American Debt Crisis, Asian Financial Crisis, etc…), or forecasts (for the brave or opinionated, e.g. future of the CNY as a reserve currency, long-term impact of oil production on Brazilian balance of payments, impact of aging on the JPY, etc…). VoxEU is a good source of inspiration for current issues in international economics.
- Questions should be answered using macroeconomic analysis, as opposed to taking a historical, political or psychological approach. For instance, a topic exploring risk premia in different bond markets could reasonably include significant material on political dynamics that generate risk for domestic bonds, but a detailed discussion of such would not be appropriate for this assignment.
- Direct overlap with topics for other classes like Econ 460 or a senior thesis is not allowed, but synergy is encouraged. For instance, if you are writing on external debt crises in developing countries for Econ 460, there should be enough room for two distinct but related topics under that umbrella. I expect students to honestly inform me about potential overlap (see section on honor code).
- Proposed questions should be submitted via email by 9am Nov 27 along with a single paragraph of further explanation about your approach (not background to the issue) and at least one reference that you have meaningfully relied on in the paragraph. You can, of course, submit questions earlier than Nov 27, but I would encourage you not to make up your mind too early – some of the most inspiring material gets covered at the end. We will schedule a 15-minute mtg to discuss your question no later than Nov

28, and you must submit a final question that meets my agreement by 5pm Nov 30. [Students enrolled in Econ 460 should also include their topics for both of those research papers (one if choosing the long paper option) with their proposed topics so we ensure sensible distiction.]

- The word limit is a hard limit, but my expectations for what you can accomplish within that limit are high. Descartes famously said, "I would have written a shorter letter if I had more time." This assignment challenges you to meet my standards of adequately addressing an interesting question in a pithy manner. Take this into account in constructing your questions.
- Aim for more than 5 references that are meaningfully relied upon in the paper. Any time you use someone else's material, you should document that through references. But the paper should not be chock-a-block with references, because you need to have plenty of your own thoughts in it. I prefer you not quote directly unless using the reference's own words is key to making your point (e.g. the phrasing of a central bank statement may carry important signaling information). References can be included in any format (APA style, footnotes, endnotes), but do not count towards the word limit.
- Charts and tables are encouraged, since they convey a lot of information with few words. Statistical analysis is event better. None of it will count towards your word limit.

IV. Honor Code

- Limited collaboration with other students on problem sets and papers is fine. The work should be your own, but there's no problem with asking for help on a tough point, how to best phrase a point you want to make, or where to find a reference or key point in the text. Similarly, if asked for help, refrain from giving the answer. Rather, give enough of a nudge to keep the person moving forward on their own.
- Papers are individual, not group, projects. Accordingly the ideas, analysis, research and writing should be your own. But I encourage you to discuss your topics with fellow students, Nigel, myself or other faculty to make them stronger.
- As discussed above, students are expected to discuss any potential overlap between your paper topic and other concurrent obligations with me. Re-using material from past courses is strictly forbidden.

V. Course Outline

1. *Foreign exchange markets*: exchange rates, FX market structure and products, cross-border investment, foreign interest rates and interest parity
2. *Financial determinants of exchange rates*: money supply and demand, inflation, explaining FX volatility, overshooting
3. *Economic determinants of exchange rates*: purchasing power parity (PPP), Fischer effect, real exchange rates and real interest parity, monetary approach to exchange rates

4. *Output and exchange rate determination*: Developing a macroeconomic model of output and exchange-rate determination in the short run
5. *Balance of payments*: Accounting for flows of goods and payments, understanding the current account and its key drivers, stabilizing the capital account and foreign debt sustainability.
6. *Exchange rate regimes:* Fixed, floating, crawling pegs, how flexible are exchange rates, evidence on pass-through, central bank intervention
7. *Monetary and fiscal policy under different FX regimes*: Effectiveness of stabilization policies, capital flight and balance of payments crises, why do countries fix their exchange rates? Internal and external balance, open economy trilemma
8. *Optimum currency areas and Europe*: Optimum Currency Area theory, Eurozone history and structure, current crisis
9. *The international monetary system*: Gold standard and Bretton Woods systems, the case for floating exchange rates, global imbalances, IMF and alternatives, Chinese exchange rate policies
10. *Financial integration*: Cross-border investment flows, banking and regulation, upstream capital flow puzzle, capital controls
11. *Challenges for emerging and developing countries*: Accessing debt markets, spillovers from major markets, sudden stops and balance of payments crisis, fear of floating